DEPARTMENT OF STATE REVENUE

02-20110251.LOF

Letter of Findings Number: 02-20110251
Corporate Income Tax
For Years 2004 through 2009

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ISSUES

I. Adjusted Gross Income Tax – Nexus.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-38; 15 U.S.C. § 381; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); Indiana Dep't of Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981).

Entity maintains that it lacked taxable nexus in Indiana.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Entity protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

This protest involves consideration of the activities of two related companies: (1) a limited liability company that was assessed Indiana adjusted gross income tax ("Entity"), and (2) a related corporation that engaged in retail transactions in Indiana but was not assessed Indiana adjusted gross income tax ("Retail Merchant"). In the protest letter and at hearing, Entity, as the company subjected to Indiana tax, represented its facts and those of Retail Merchant.

After an audit investigation, the Indiana Department of Revenue ("Department") determined that Entity had failed to remit Indiana corporate adjusted gross income tax for the years 2004 through 2009. Accordingly, the Department determined that Entity owed the tax for the years 2004 through 2009 and assessed Entity tax, interest and penalty for those years.

Retail Merchant was founded in the 1990s and is a leader in the Sci-Fi "Gaming Industry" ("Games"). Retail Merchant mostly sells Games to distributors and retailers. These Games were also available for purchase in Indiana at a convention during the years at issue. Furthermore, Retail Merchant sent most of its employees to a "retailer summit" hosted in Indiana for several days each of the years at issue. Neither Entity nor Retail Merchant filed any Indiana income tax returns for any years up through the periods at issue. Retail Merchant has since registered for an Indiana retail merchant certificate.

Entity protested the imposition of the tax, interest, and penalty arguing that it did not have any nexus with Indiana. A hearing was held and this Letter of Findings ensues. Additional information will be provided as necessary.

Please note that Entity separately protests a sales tax assessment which is addressed in Letter of Findings 04-20110298 and is issued simultaneously with this Letter of Findings.

I. Adjusted Gross Income Tax – Nexus.

Entity protests the imposition of adjusted gross income tax for the periods at issue. Entity asserts that neither it nor Retail Merchant had nexus with Indiana for these years because their business activities were protected by 15 U.S.C. § 381 ("Public Law 86-272"). Entity argues that since it does not have nexus with Indiana, the Department's assessment of additional tax on Entity is not valid. Entity also cites to Indiana Dep't of Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981) and Wisconsin Dep't of Revenue v. William Wrigley, Jr., 505 U.S. 214 (1992) in support of its protest.

As a threshold issue, although a statute that imposes a tax is strictly construed against the State, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

The adjusted gross income tax is imposed under IC § 6-3-2-2, which provides in relevant part:

(a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;

(2) income from doing business in this state;

(3) income from a trade or profession conducted in this state;

(4) compensation for labor or services rendered within this state; and

(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from

the intangible is attributable to Indiana under section 2.2 of this chapter.

In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter) only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

. . ..

Further, 45 IAC 3.1-1-38 states:

For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

(1) Maintenance of an office or other place of business in the state

(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods

(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution

(4) Rendering services to customers in the state

(5) Ownership, rental or operation of a business or of property (real or personal) in the state

(6) Acceptance of orders in the state

(7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).

Public Law 86-272 prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales (generally referred to as "mere solicitation"). In other words, a state may not impose an income tax on income derived from business activities within that state unless those activities exceed the mere solicitation of sales.

As Entity quotes in a letter sent after the hearing (dated November 16, 2011), the Indiana Supreme Court explained in Indiana Dep't. of Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981):

Public Law 86-272 (15 U.S.C.A. § 381), in pertinent part is as follows:

(a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

Id. at 1265.

The court then explained:

We also believe that Congress perceived "solicitation" as embodying "sundry activities so long as those activities [are] closely related to the eventual sale of a product." Finally, when a corporate representative performs an "act of courtesy" in order to accommodate a customer, he has not ventured beyond the realm of "solicitation."

Id. at 1268 (internal quotes omitted).

The United States Supreme Court explained its standard for determining "solicitation of sales" in Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992). In Wrigley, the Court explained:

We proceed, therefore, to describe what we think the proper standard to be. Once it is acknowledged, as we have concluded it must be, that "solicitation of orders" covers more than what is strictly essential to making requests for purchases, the next (and perhaps the only other) clear line is the one between those activities that are entirely ancillary to requests for purchases -- those that serve no independent business function apart from their connection to the soliciting of orders -- and those activities that the company would have reason to engage in any way but chooses to allocate to its in-state sales force. National Tires, Inc. v. Lindley, 68 Ohio App. 2d 71, 78-79 426 N.E.2d 793, 798 (1980) (company's activities went beyond solicitation to "functions more commonly related to maintaining an on-going business"). Providing a car and a stock of free

> samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into "solicitation" by merely being assigned to salesmen. See, e. g., Herff Jones Co. v. State Tax Comm'n, 247 Ore. 404, 412, 430 P.2d 998, 1001-1002 (1967) (no § 381 immunity for sales representatives' collection activities).
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> Id. at 228-30.
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> The Court further explained:
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> By contrast, Wrigley's in-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings served no purpose apart from their role in facilitating solicitation. The same must be said of the instances in which Wrigley's regional sales manager contacted the Chicago office about "rather nasty" credit disputes involving important accounts in order to "get the account and [Wrigley's] credit department communicating." App. 71, 72. It hardly appears likely that this mediating function between the customer and the central office would have been performed by some other employee -- some company ombudsman, so to speak -- if the on-location sales staff did not exist. The purpose of the activity, in other words, was to ingratiate the salesman with the customer, thereby facilitating requests for purchases. Finally, Wrigley argues that the various nonimmune activities considered singly or together, are de minimis. In particular, Wrigley emphasizes that the gum sales through "agency stock checks" accounted for only 0.00007 [percent] of Wrigley's annual Wisconsin sales, and in absolute terms amounted to only several hundred dollars a year. We need not decide whether any of the nonimmune activities was de minimis in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose, as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through "agency stock checks." Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State. Because Wrigley's business activities within Wisconsin were not limited to those specified in § 381, the prohibition on net-income taxation contained in that provision was inapplicable.
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> Id. at 234-5.

Entity's reference to the above cited cases is to establish that the "mere solicitation" of business in a state and activities closely related to the "mere solicitation" of business do not establish nexus with a state for income tax purposes. Entity also references Wrigley to demonstrate that even trivial non-solicitation contact with a state does not establish nexus for income tax purposes since the "trivial contacts" are "de minimis." Apart from this latter reference, however, Entity does not elaborate on the particular dimension of trivial non-solicitation contact with a state that purportedly does not establish nexus.

It is clear that Entity does not come into Indiana for the "Retailer Summits" nor does it have a presence at the convention that took place in Indiana during the periods at issue. Entity was formed in January of 2010 and did not, for the periods at issue, have nexus with Indiana.

However, the same cannot be said for Retail Merchant. The clear fact is that Retail Merchant's activities in Indiana go beyond "mere solicitation" and activities closely tied to "mere solicitation." As a leader in its industry, Retail Merchant has a large presence at the convention that took place in Indiana annually during the periods at issue and made significant sales in Indiana at that time. These activities exceed "mere solicitation" and also exceed the "de minimis" activities Entity argues are trivial non-solicitation activities. If the Department had assessed Retail Merchant, Indiana adjusted gross income tax would have been properly due. For purposes of this protest, though, Entity has met its burden under IC § 6-8.1-5-1(c).

FINDING

Entity's protest is sustained.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Entity protests the imposition of the negligence penalty assessed on the income tax the Department found Entity owed pursuant to the investigation conducted by the Department.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1. The Indiana Administrative Code, 45 IAC 15-11-2 further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and

circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Department's investigation imposed penalty because ordinary business care and prudence requires that a taxpayer be aware of their tax obligations. Furthermore, neither Entity nor Retail Merchant were, at the time, registered for sales and use tax purposes.

Entity must demonstrate that it had reasonable cause for not paying the full amount of adjusted gross income tax due. In order to establish reasonable cause, Entity must demonstrate that it exercised "ordinary business care and prudence" in conducting the duties from which the additional tax and penalty arose. 45 IAC 15-11-2(c).

Since Entity was incorrectly assessed the adjusted gross income tax, the question of penalty is moot.

FINDING

Entity's protest of the negligence penalty is sustained.

SUMMARY

Entity is sustained on both its protest of the imposition of adjusted gross income tax and penalty.

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